Financial Service Regulation and Business Models: Post Gramm-Leach-Bliley

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Discussion Points

- Financial Modernization Legislation
- Financial Service Business Modes
- Discussion and Questions

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

- Permitted banks and bank holding companies to purchase banks or establish subsidiary banks in any state nationwide.
- Permitted national bank to open branches or convert subsidiary banks into branches across state lines.

	1994	2001	Change	% Change
Commercial Banks	10,452	8,080	(2,372)	-22.69%
Branches	55,145	64,954	9,809	17.79%
Total Offices	65,597	73,034	7,437	11.34%
Total Assets ($ Trillion)	4010.0	6,569	2,559	63.82%
Savings Institutions	2,152	1,533	(619)	-28.76%

Gramm-Leach-Bliley Financial Modernization Act of 1999

- Created a financial holding company (FHC) that can engage in all authorized financial service activities.
- Created a financial subsidiary for banks that can engage in most of the authorized financial service activities.
- Newly authorized activities--securities, insurance, merchant banking/equity investment, "financial in nature", and "complementary activities."

Gramm-Leach-Bliley Financial Modernization Act of 1999

- Repeals prohibition against affiliation of banks with a securities affiliate.
- Amends the Riegle-Neal Act to apply to any branch of a bank owned by an out-of-state BHC.
- Repeals prohibition against interstate branching by an out-of-state bank primarily to establish deposit production offices.

Gramm-Leach-Bliley Financial Modernization Act of 1999

- Mandates State functional regulation of insurance sales activity (including a national bank exercising FRA agency powers).
- Gave the federal Reserve & the Treasury discretion to authorize new financial activities or complementary activities for FHCs.
- Established the Federal Reserve as the "umbrella" regulator for FHCs.

Financial Service Business Modes: Post GLB

- Complex, Global, Diversified Model
- Focused Domestic Model
- Community Bank Model

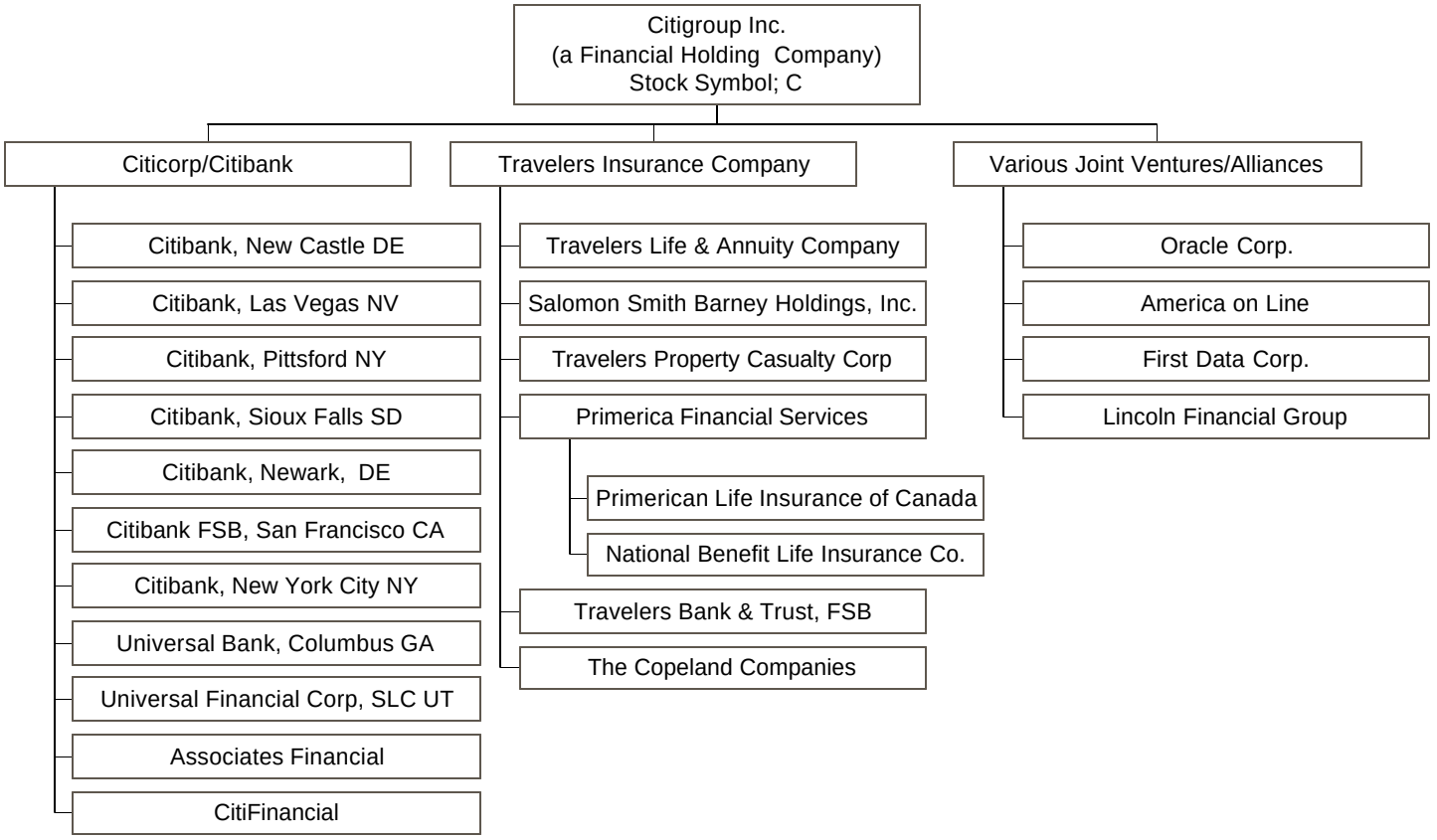
Complex, Global, Diversified Model: Citigroup

- Total Revenues: $112.0 billion
- Net Income: $14.1 billion
- Total Assets: $1,051.5 Billion
- Total Stockholders Equity: $81.2 billion
- Return on Common Equity: 19.7%
- Countries and Territories Served: 100+
- Customers: 100 million+
- Full Time Equivalent Employees 268,000

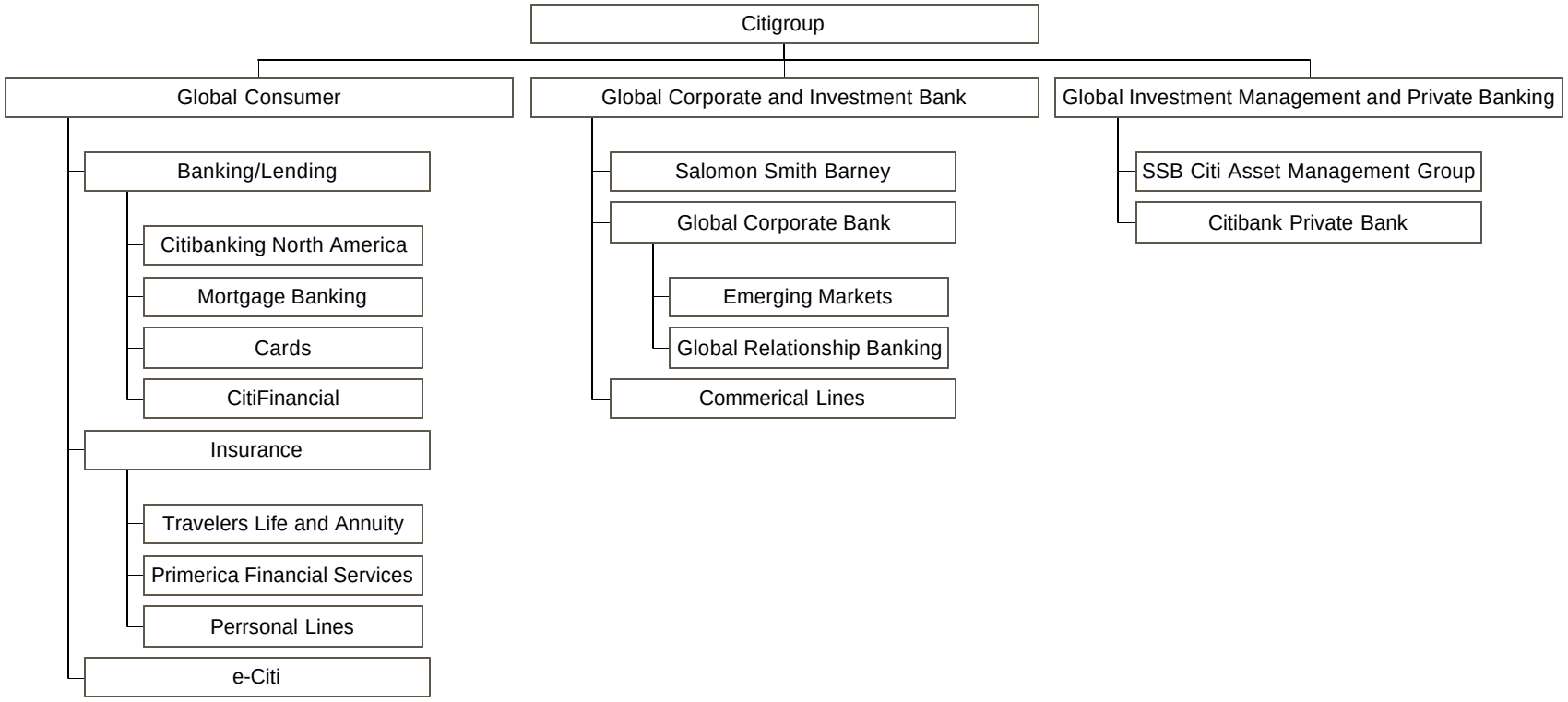
Evolution of Citigroup

Date	Acquirer/Surviving Name	Acquired/Merged
1987	Primerica	Smith, Barney, Harris
1993	Primerica	Shearson Lehman
1993	Travelers Group	Primerica
1997	Travelers Group	Salomon Brothers
1998	Travelers Group	Citicorp
1998	Citigroup	

Citigroup Corporate Structure



Citigroup Market Structure



Cross Marketing Efforts

Global Consumer: Banking/Lending

Employees of:	Are selling products and services of these firms:					
	Citibank	SSB	CitiFin.	T B&T	T L&A	T P&C
Primerica		✓	✓	✓	✓	
Citibank branches		✓			✓	
SSB	✓	✓			✓	
Citibank credit card call centers			✓	✓		✓
Travelers Property Casualty	✓					

Internet Growing Importance

- 50 plus internet sites provided.
- Some transactional, some informational.
- Objective is to sell and service virtually.
- Currently state they have 15 million on-line customers

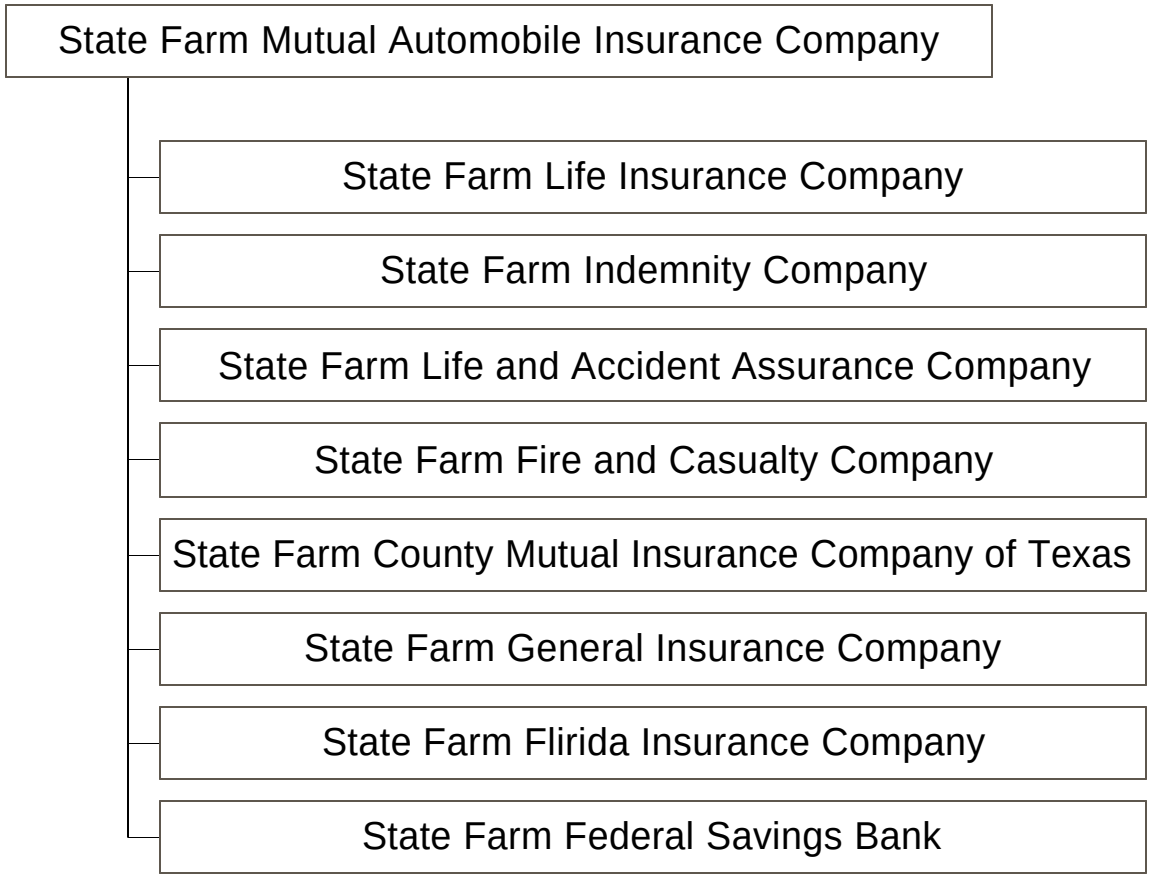
“Citi on the net” stated objectives

- Provide a comprehensive suite of consumer financial products and services, accessible anywhere, on any device, at any time, in a secure and private manner.
- Build the consumer payments engine of the internet.
- Provide internet-based transaction services to our corporate customers and be the financial services engine that powers business-to-business exchanges.
- Lead the development of internet-based capital markets.
- Use the Web to increase productivity, drive down operating costs and better serve our customers.

Focused, Domestic Model: State Farm

- Mutual company without shareholders
- Total Assets $71.1 billion
- Net Income ($2,646) million
- Policies in force 71.6 million
- Serves 50 states, District of Columbia and three Canadian provinces
- Employees 79,214
- Agents 16,749+

State Farm Companies



State Farm Bank

- Charter granted November 1998
- Bank opened March 12, 1999
- Initially available only to residents of central Illinois and St Louis MO
- Currently agents trained in 5 states (IL, MO, NV, AZ & NM) and going on in 6 others (AL, MS, IN, CO, UT, & WY)
- Doesn’t have branches
- Accessible via agents, internet, toll free telephone and the mail

Results through 6/30/2000

- Total assets $3,113.6 million
- Mortgage loans $711/5 million
- Auto loans $705.2 million
- Credit Card loans $158.6 million
- Deposits $2,423.1 million
- Annualized profitability ($28.6 million)
- ROA (2.54%), ROE (24.23%)

What's the strategy?

- To get some or all of the financial services of their 27 million plus households and agents.

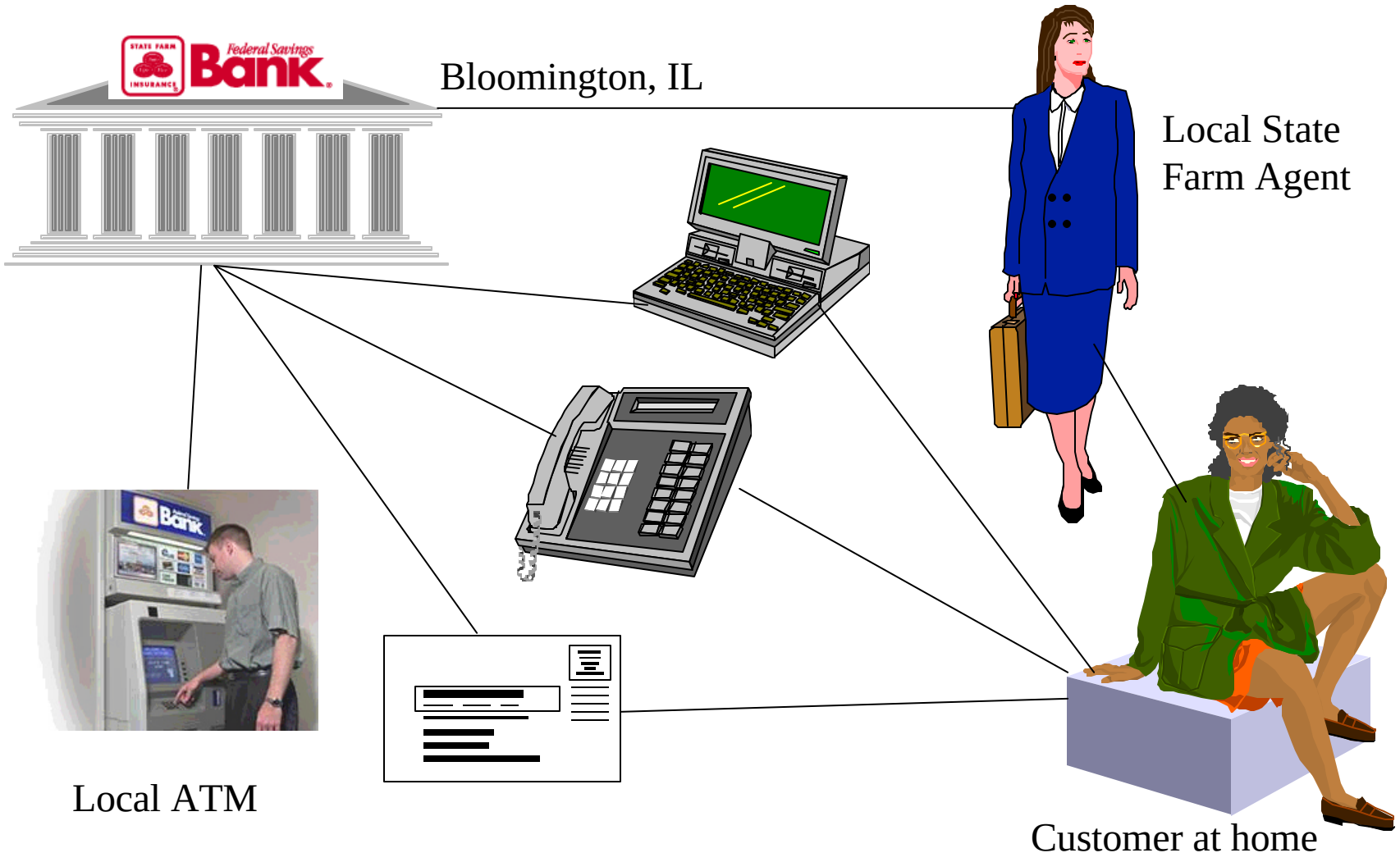
- Sell banking services to insurance policy clients

- Cross-sell multiple bank services to single service users

How will they do it?

- They have the name and address of existing customers.
- Agents are adding new insurance customers daily.
- Direct marketing to insurance customers.
- Attractive product pricing.
- In field sales force of 16,000+.
- Product bundling.
- Referrals from existing banking customers.

What it looks like.



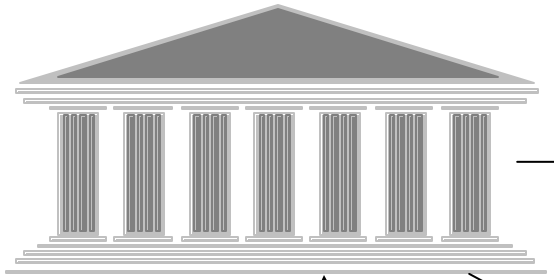
Community Bank Model

- 8,000 plus community banks nationally
- Competitive advantage historically customer service
- Limited product lines and marketing resources
- Many located in marketing with declining populations
- Internet banking reception mixed

Reaction to GLB

- Mixed, some became FHC some haven't done anything.
- Some that became FHC haven't passed increased standards at examination.
- Most that have expanded have done so in the insurance agency arena.
- Some have gone in different directions.

Local insurance agency and bank



Local Bank

Bank or FHC Acquires

Local Insurance Agency

Bank reps sell bank and insurance services.

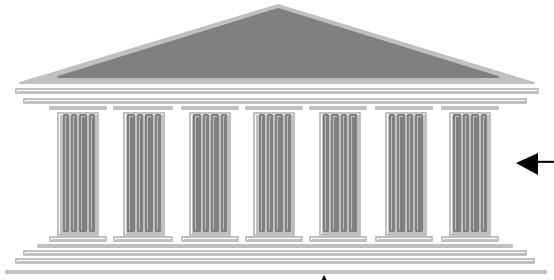
Agents sell insurance and banks services.

Direct marketing approaches to each others customers.

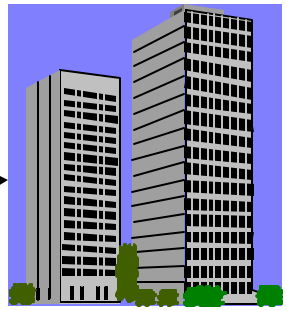
Bank Customer

Agency Customer

Third party investment firm and bank



Local Bank



Solomon Smith Barney

Bank agrees to place SSB reps in office for share of revenue.

Bank reps sell bank services and refer on other investments.

Bank Customer

Conclusion

- Large banking companies are increasingly complex and selling services to all customers from other corporate subsidiaries located in another state though all possible marketing channels.
- Community banks are still largely locally focused but may be selling or having sold services to customers of other companies from which they share in the profit.
- Increasingly internet banking is replacing higher cost sales and servicing alternatives and is eliminating any geographic or time barriers.

The Impact of Federal Deregulation on State Income Taxation of the Financial Services Industry

2002 California Tax Policy Conference
Sacramento, California

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The Impact of Federal Deregulation on State Income Taxation of the Financial Services Industry

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I. Introduction.[1]

A. In the past, federal law has prevented a number of companies in the securities, bank and financial, and insurance industries from operating as members of a commonly owned affiliated group of corporations. As a result, the state income tax laws with respect to each industry type have been developed relatively independently. The broad effect of federal deregulation of the financial services industry will be that a number of financial service businesses will be allowed to operate under common ownership.

B. As a result it will now be theoretically possible for these industry types to constitute members of a unitary group. Under the unitary business principle (*Edison California Stores v. McColgan* (1947) 30 Cal.2d 472), the entire pool of "business income" of the members of a unitary group are aggregated in a common apportionment base, and apportioned under a common formula to the various states in which the members of the unitary business conducts its business enterprise. In most cases, the apportionment formula consists of some variation of the traditional payroll, property, and sales factors.

C. In a number of states where the unitary business principle is applicable, unitary treatment is mandatory (*Superior Oil v. Franchise Tax Board* (1963) 60 Cal.2d 406; *Honolulu Oil Corp. v. Franchise Tax Board* (1963) 60 Cal.2d 417). If the concept of mandatory combination is applied to the financial services industry, then, despite the apportionment difficulties presented in the combination (discussed below) the state must make an accommodation to the unitary business principle.

II. How Likely is Unitary Combination under Deregulation?

A. How likely is it that banks, financials, securities businesses, and insurance businesses will exhibit unitary characteristics? The traditional unitary indicators that could cause a unitary relationship include strong central management and centralized departments, intercompany lending, common advertising and marketing, common customer base, intercompany sales, common sales force, transfer of technologies and business information, etc. Will the financial deregulation environment permit these traditional ties to come into existence?

[1] The comments in this paper are those of the speakers and do not necessarily represent the views of their respective employers.

1. How likely will it be that the commonly owned businesses will exhibit strong central management and centralized departments?

2. Will the commonly owned businesses permitted to engage in use of common trade names and common advertising? Can the companies share customer lists? Can promotional materials for one business type be included in the billing statements of the other?

3. Will one commonly owned businesses type be able to set up kiosks or offices within another business type's customer service area, creating, from the perspective of the customer, "one stop financial shopping" network?

4. Will employees of one business be able to sell or at least market the sale of financial products of the other? Is there any regulatory limitation that would prevent a parent from directing its employees to encourage customers of one business type to utilize the services or financial products of the other business types?

5. Will one business type be able to sell instruments or services that was traditionally sold by another business type? For example, can a savings and loan sell annuities that are also sold by an insurance company? Can a bank, or its subsidiary, underwrite securities? To what extent can the various business types share business knowledge and marketing expertise?

6. What restrictions, if any, will there be on the movement of funds between the various business types?

B. Assuming that a unitary relationship can exist between the members of the banking, financial lending, securities, and insurance industries, combination of these industries are likely to create significant apportionment issues. As will be discussed in greater detail below, each industry group has had its own set of apportionment rules that have independently evolved over time. It will be a significant issue to determine how the various rules of apportionment integrate with one another in a unitary combination.

C. Before the issues of combination are discussed, a review of the state apportionment rules and tax treatment of each of the industry types follows below.

III. Apportionment of Banks and Financials—Defining the Financial Corporation

A. Definition of a Financial Corporation--California.

1. The apportionment rules for financial corporations (Cal. Code of Regs., tit. 18,[2] §25137-4.2) first require a determination whether a particular business is a properly characterized as a financial corporation. For that purpose, California looks to the definition of a financial corporation in regulations under 18 CCR §23183.

2. The reason why financial corporations are defined in that section is that, for historical reasons, under §§23181, 23183, and 23186 of the California Revenue and Taxation Code,[3] California imposes a 2% higher tax rate on the income of banks and financial corporations (currently 10.84%) than is applicable for general corporations (currently 8.84%). The higher tax rate (sometimes referred to as the "in lieu" rate) compensates for the fact that banks and financial corporations are exempt from business license taxes and personal property taxes generally imposed by cities and counties (CRTC §23182; art. 13, §27, Cal. Constitution).

3. 18 CCR §23183 defines a financial corporation as a corporation "which predominantly deals in money or moneyed capital in substantial competition with the business of national banks." The word "predominantly" is defined as over 50% of a corporation's total gross income. Special rules apply to retain the financial corporation status if the corporation has minor year-to-year variations in that percentage below 50%.

4. Note that it is "gross income" that defines a financial corporation, as opposed to "gross receipts." This distinction is significant, and can produce some interesting effects in other contexts.

    a. For example, California generally apportions income of a corporation (or a group of corporations) by reference to four-factor formula, consisting of a property factor, a payroll factor, and a double weighted sales factor (CRTC §25128).[4] However, if a taxpayer (or a unitary

[2] Hereafter cited as "18 CCR."
[3] Hereafter "CRTC."
[4] CRTC § 25128 provides that if more than 50 percent of the "gross business receipts" of the unitary business is attributed to "bank or financial activity" and "savings and loan activity" then the sales factor is single weighted. CRTC § 25128(d)(1) defines "gross business receipts" by referencing CRTC §25120(e), the standard Uniform Division of Income for Tax Purposes Act (UDITPA) definition of gross receipts, excluding nonbusiness receipts that are allocated. Intercompany receipts between combined group members are excluded from "gross business receipts." Receipts that would otherwise be excluded by operation of CRTC § 25137 (the equivalent to UDITPA § 18) are included in the calculation of "gross business receipts." Thus, for purposes of CRTC §25128, the "netting rules" in the financial apportionment regulations (18 CCR §25137-4.2) do not apply. CRTC § 25128(d)(5) defines "savings and loan activity" as any activities performed by savings and loan associations or savings banks that have been chartered by federal or state law. CRTC § 25128(d)(5) defines "bank or financial business activity" as activities attributable to dealings in moneyed capital in substantial competition with the business of national banks, a similar standard (other than the use of "gross receipts" to measure predominate activity) to that applied under 18 CCR §23183.

group of corporations) has both general corporate activity and financial activity, and the financial activity predominates, the taxpayer (or group) is required to apportion using a three-factor formula (using evenly weighted payroll, property and sales factors). For purposes of that test, "gross receipts" is used to determine the predominant character of the taxpayer (or group). Loans made to affiliated corporations are sufficient to meet the definition of financial corporation under 18 CCR 23183. (*Delta Investment Co., Inc and Delta Investment Research Corp (*Cal. St. Bd. of Equal., SBE 78-SBE-017*))* This approach can be contrasted with CRTC §25128, which eliminates intercompany receipts when determining the weight of the sales factor.

b. Thus, in theory, a corporation could be a financial corporation under one set of rules (e.g., for purposes of tax imposition under Section 23183, and for purposes of the apportionment rules that incorporate Section 23183) and not be a financial for purposes of another (e.g., the single weighted sales factor).

(c) However, a three-factor formula (single weighted sales factor) is also contained within the provisions of the financial apportionment rules under 18 CCR §25137-4.2(a)(2). Thus, it is likely that a three-factor formula might well be appropriate in a close case where the different rules produce different results, even if it is necessary to resort to the basic authority of §25137 to do so (see further discussion below regarding the general use of §25137).

5. Issues: Are CRTC §23183 and its regulations out of date? Is the business of a bank sufficiently limited to "dealing in moneyed capital" to use as a comparative for purposes of defining a financial corporation? Is the different rate for banks and financials (with offsetting of exemption from business license taxes, and personal property taxes) still appropriate? Should there be some commonality between the rules that define a financial corporation for rate purposes and for single or double weighting under §25128?

B. Definition of a Financial Corporation—Other States.

1. The MTC model financial apportionment regulations (discussed in greater detail below) did not include a definition of financial institution, but provided a model definition in Appendix A in its final report. That model definition is also attached to this outline as Appendix A. In general, the MTC definition adopts a standard which specifically incorporates a number of state bank, thrift and credit union authorities, as well as federal banking and national housing acts, federal deposit insurance acts, foreign depositories, farm production credit associations. Also included are certain finance lease companies. Similar to the

California regulation, the MTC definition also includes a 50% gross income test for entities are in substantial competition with entities that do business in these areas, but unlike the California test, the gross income test is not limited to "dealing in moneyed capital." The MTC model rules (model rules j. and k.) generally *exclude* insurance companies, real estate brokers, and securities businesses from the application of the 50% test. Subsidiaries (other than insurance companies) owned, directly or indirectly, by a financial corporation are also considered financial corporations.

2. Other states that have not adopted the MTC model financial apportionment regulations may either apply its general corporate income tax apportionment rules to banks and financial corporations (e.g., Arizona).

IV. Apportionment of Income of a Bank or Financial Corporation.

A. California. California's financial apportionment regulations were adopted from model regulations promulgated by the Multistate Tax Commission (MTC). In general, those regulations reflect the market state for purposes of the sales factor. Note that in many cases, only the net gain on the sale of various financial instruments is considered for purposes of the numerator and denominator of the sales factor. In the property factor rules, the MTC model regulation tends to reflect the contributions of the money-centered states. Also note that, unlike the standard property factor rule (which includes only tangible personal property and real property in its measure), the financial apportionment property factor includes loans and credit card receivables. These rules are summarized below. See the attached Appendix B, for more detailed information.

1. **Sales Factor.**

a. The sales factor is the standard sales factor (18 CCR §25137-4.2(a)(2) and (c)(3)(M)), except to the extent provided by special rule. The denominator of the sales factor ("receipts factor" in the regulation) includes special rules for:

(1) Interest, dividends, net gains (but not less than zero) and other business income from investment assets and activities and from trading assets and activities.[5]

(2) Special rules apply to reduce the gross receipt amounts for federal funds sold and repurchase agreements, by the interest expense related to such agreements. Similar rules apply to trading assets and activities and foreign currency, to reduce the

[5] Investment assets and activities and trading assets and activities include but are not limited to: investment securities; trading account assets; federal funds; securities purchased and sold under agreements to resell or repurchase; options; futures contracts; forward contracts; notional principal contracts such as swaps; equities; and foreign currency transactions.

gross receipt amounts by amounts paid in lieu of interest, dividends and losses from such assets and activity.

(3) Net gains from the sale of loans, and income recorded under the coupon stripping rules of Section 1268 of the Internal Revenue Code (IRC).

b. The sales factor numerator provides special rules for certain types of receipts.

(1) Lease receipts are generally assigned to the state where the property is located, or first placed in service.

(2) Interest on loans secured by real or tangible property is generally assigned to the location of the property, or in some cases, the state of the borrower. The net gain from the sale of secured loans and loan servicing fees are assigned based on the ratio that interest income from the pool of secured loans is assigned.

(3) Interest on unsecured loans are generally assigned to the state of the borrower. The net gain from the sale of unsecured loans and loan servicing fees are assigned based on the ratio that interest income from the pool of unsecured loans is assigned.

(4) Credit card interest and fees are assigned based on the billing address of the customer. Net gains from the sale of credit card receivables and reimbursement fees are assigned based on the ratio that the interest income and fees from the pool of credit card receipts is assigned. Merchant discount is assigned to the state of the merchant's commercial domicile.

(5) Special netting rules apply to assign income from investment accounts, federal fund sales and purchases, and trading assets and activities. In general, such amounts are assigned to the numerator of the sales factor based on whether the assets are maintained at a regular place of business in the state. The primary factor taken into account for that purpose is where the day-to-day decisions regarding the trading assets take place.

2. Property Factor. Loans and credit card receivables are included in the property factor. No other intangibles are included. For purposes of the property factor numerator, loans and credit card receivables are assigned to the single state that is a regular place of business of the taxpayer and for which

preponderance of loan activity occurs,[6] similar to a cost of performance test. There is also a booking presumption for sourcing credit card and loan receivables.

B. Apportionment of Income of a Banks of Financial Corporation—Other States

1. The MTC regulations, discussed in detail above with respect to California, have also been adopted by several states, including Massachusetts, New Hampshire, New Mexico, Oregon, Utah, Rhode Island, and Washington. See Appendix B for a complete list of states and the dates when the rules have been adopted.

2. Some states generally subject to the Uniform Division of Income for Tax Purposes Act (UDITPA) have not adopted the MTC regulations for financial institutions and instead use the standard UDITPA rules, e.g., Arizona. In those states, intangibles are not included in the property factor and receipts are assigned for sales factor numerator purposes under the greater cost of performance method (§17 of UDITPA). In those states there is also an issue of whether gross receipts should be used in the sales factor for the sale of loans and securities, or whether §18 of UDITPA can be invoked to include those sales using only net income. There is also an issue whether loans should be included in the property factor under Section a UDITPA §18 petition. [7] See e.g., *Crocker Equipment Leasing, Inc. v. Department of Reve*nue, 838 P.2d 552 (OR 1992).

3. New York. Banking corporations are subject to tax under Article 32. The term banking corporation includes a corporation which is 65% or more owned or controlled by a banking corporation (which includes commercial banks, trust companies, savings banks, and savings and loan association) or bank holding company, which is engaged in a business lawful to a New York commercial bank or national bank association, or is so closely related to banking or managing or controlling banks as to be a proper incident thereto as defined in section 4(c)(8) of the Federal Banking Holding Company Act of 1956. The apportionment factors consist of a payroll factor, deposits factor, and a receipts factor with rules similar to the MTC financial regulations for sourcing loans.

[6] The regulation presumes that the preponderance of substantive contact to be based on the following factors: solicitation, investigation, negotiation, approval, and administration.

[7] Section 18 of UDITPA provides that if the allocation provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the (tax administrator) may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) separate accounting; (b) the exclusion of any one or more of the factors; (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

4. Other Approaches. Still other states apply a special formula to apportion the business income of financial institutions. For example, a single sales factor formula is applied by Connecticut, South Carolina and Tennessee. Virginia is unique in that it utilizes a single cost of performance ratio to apportion the business income of financial organizations that are not subject to the bank franchise tax.

V. Apportionment of Income of Securities Dealers

A. California. California does not provide any special industry regulations for securities dealers. In general, the payroll and property factors are determined under the normal UDITPA rules. In addition, the sales factor denominator also reflects the normal UDITPA rules. However, the Franchise Tax Board provides some special industry practices with respect to this industry in its Multistate Audit Technique Manual (MATM).

1. Underwriting and principal trading receipts. In *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, Cal. St. Bd. of Equal., 89-SBE-017, [1986-90 Transfer Binder] Cal. Tax Rptr. (CCH) ¶401-740, at 25,554 (June 2, 1989), the Franchise Tax Board argued that Merrill Lynch's sales factor should reflect its underwriting and securities sales at gross profit rather than gross receipts. The Franchise Tax Board asserted that the use of gross receipts had the effect of distorting the taxpayer's sales factor, when that activity was compared to its stockbroker activity, which was a pure service and did not have an associated sale of property. The Board of Equalization stated that a mere mathematical difference between one method and another was not proof of distortion. Because underwriting and securities sales were part of Merrill Lynch's principal business activities (and not a mere ancillary activity) it was appropriate to use gross receipts rather than gross profits from such sales.

2. Special practices. In MATM ¶7800, the Franchise Tax Board applies special numerator rules for the assignment stockbrokers commission income. Commission income is generated from the buying and selling of stocks or bonds for a customer's account. The stockbroker never actually takes title to the stocks or bonds, but merely earns a fee for arranging the transaction. The normal rule for assigning such receipts would be to apply the greater cost of performance analysis of CRTC §25136 (§17 of UDITPA). However, because customers who use the services of a broker engage both the services of the local branch, as well as the services of the exchange (commonly in New York, but also possibly the Pacific Exchange in California), the Franchise Tax Board treats commission fee receipts for stock sales as 60% attributable to the originating office, and 40% attributable to the state of the exchange. If no exchange is involved the sale is 100% assigned to the originating office. In the

case of bond commissions, 50% of the commission is assigned to the originating office and 50% to the state of the exchange.

3. Although the MATM does not so state, the division of these receipts in the manual appears similar to the effect of the rule for personal services, which treats a receipt for personal services as divisible between the states based on the respective time in each state used to perform the service (18 CCR §25136(d)(2)(C)).

4. Note that there is no property factor representation for the intangible assets of securities dealers, despite the fact that securities dealers may have large inventories of securities available for trading on their own account (so called principal trading assets).

B. Apportionment of Income of Securities Dealers, Other States.

1. UDITPA States. Certain states have adopted the UDITPA approach, where receipts are assigned for sales factor numerator purposes under the greater cost of performance method. Thus, the all-or-nothing approach would apply to sourcing commissions in these states.

2. Customer Location. Assigning receipts to customer location removes a barrier from financial service providers locating in a particular state.

New York - Securities Dealers are subject to tax under Article 9-A. (Article 9-A also taxes other general corporations such as retailers and manufacturers.) For tax years beginning on or after January 1, 2001 brokerage commission, margin interest, and account maintenance fees are assigned to customer location.

New Jersey - Effective 1/1/2002 receipts from brokerage services and the receipts from asset management services are assigned to New Jersey if the customer is located in New Jersey.

VI. Tax Treatment of Insurance Companies

A. Taxation of Insurance Companies in California.

1. Corporations that do insurance business in California are subject to a gross premiums tax of 2.5% of “the amount of gross premiums, less return premiums, received in such year by such insurer upon its business done in this State (art. 13, §§28(c) and (d) of the California Constitution). The gross premiums tax is "in lieu of all other taxes" (art. 13, §28(f) of the California Constitution; *First American Title Insurance & Trust Co. v. FTB* (1971) 15 Cal.App.3d 343).

2. In Legal Ruling 385 (1975), the Franchise Tax Board legal branch held that the in lieu provision of the California Constitution also prevents combination of insurance companies in a combined report of a general corporation, even if the insurance company and the general corporation are unitary. To treat all general corporations and insurance companies uniformly, the ruling also excludes insurance companies operating entirely outside of California from the combined report. The exclusion applies to companies that are "regularly engaged in an insurance business, and that are licensed as such and subject to regulation under the laws of the state(s) where they operate."

3. Captive Insurance Companies.

    a. Captive insurance companies are insurance companies that principally provide insurance for the members of its affiliated group. Because captive insurance between affiliates can be seen as a form of self insurance, under federal law, in some circumstances, the members of the affiliated group are not allowed a deduction for premiums paid between members, and can deduct losses only when they occur. (*AMERCO v. Comm'r*, 96 TC 18, 979 F.2d 162 (9th Cir. 1992); *The Harper Group v. Comm'r*, 96 TC 45, 979 F.2d 1341 (9th Cir. 1992); *Sears Roebuck & Co. v. Comm'r*, 96 TC 61, 972 F.2d 858 (7th Cir. 1992).

    b. The Franchise Tax Board's Multistate Audit Technique Manual ¶5190 applies Legal Ruling 385 to captive insurance companies, excluding their income and apportionment factors from the combined report. The reason for that exclusion is the California Department of Insurance applies the gross premiums tax equally to all admitted insurers without distinguishing between captive and noncaptive insurers. Thus, the "in lieu" provisions of art. 13, §28(f) of the California Constitution also applies to captive insurance companies. Accordingly, the Franchise Tax Board considers a captive insurance company to be an insurance company for purposes of Legal Ruling 385.

4. Taxation of Dividends Received by a Taxable Corporation from an Insurance Corporation.

    a. Because insurance dividends are gross income under IRC §61, they are included in net income of a taxable corporation for California purposes (CRCT §24271). If there is a functional business relationship between the insurance company and the taxable corporation, the dividends are considered apportionable business income. (*Appeal of Dial Finance Co. of California*, Cal. St. Bd. of Equal., 93-SBE-004, Feb. 10, 1993: *Appeal of Control Data Corp., et al.*, Cal. St. Bd. of Equal. (96-SBE-002)).

b. §24110 allows a partial deduction for insurance company dividends. There are for conditions in the statute for the deduction: 1) the recipient must be domiciled in California, 2) the insurance company must be at least 80% held, 3) the insurance company must be subject to the gross premiums tax, and 4) the dividend relief is paid by reference to an apportionment percentage of the insurer consisting of modified payroll, property, and sales factors.

c. The commercial domicile limitation and the formulary relief provision of §24110 were held to be discriminatory under the Commerce Clause of the U.S. Constitution in *Ceridian Corp. v. Franchise Tax Board* (2000) 85 Cal.App. 4th 875 (modified 86 Cal.App. 4th 383). The Franchise Tax Board argued that the appropriate remedy for the constitutional defect was to retrospectively invalidate the section for all taxable years, citing CRTC §19393. The Court of Appeal held that to apply that section retrospectively to years closed to the normal four-year statute of limitation violates a taxpayer's right to due process where the retroactive assessment it provides cannot lawfully be collected. Thus, the taxpayer was entitled to a refund reflecting a 100% dividend deduction. As a remedial matter, for years beyond the normal four-year statute of limitations, the Franchise Tax Board will allow a 100% deduction for insurance company dividends that meet the 80% ownership test, subject to the effects of CRTC §24425.[8]

d. It is the position of the Franchise Tax Board staff that, because §24110 was declared unconstitutional, and cannot be reformed, it is invalid and unenforceable (see *Kopp v. Fair Political Practices Commission* (1995) 11 Cal.4th 607). Since the *Ceridian* decision, the FTB has maintained that only the legislature can correct the unconstitutional scheme by adopting new law. Thus, in the absence of legislative action, the deduction provided under that section has no legal effect. Because insurance company dividends are taxable under §24471, they are wholly taxable for years within the normal four-year statute of limitations (1997 and thereafter), for which the Franchise Tax Board is permitted to assess. The California legislative counsel

[8] CRTC §24425 disallows expenses that are allocable to income that is "not included in the measure of the tax imposed by this part…" Thus, to the extent that a taxable corporation receives an exempt dividend, §24425 may operate to deny deductions related to the exempt dividend. This principle applies to general corporate dividends deductible under CRTC §24402 (*Great Western Financial Corp. v. Franchise Tax Board (1971) 4 Cal.3d 1)*, as well as exempt insurance dividends (*Appeal of Zenith National Insurance Corporation*, Cal. St. Bd. of Equal. 98-SBE-001). The *Zenith* opinion applied the tracing and allocation rules applicable under IRC §265, and Rev. Proc. 72-18, 1972-1C.B. 740, to do the allocation required under CRTC §24425.

has issued an opinion to similar effect (Letter to Sen. John Burton, dated December 7, 2001, entitled "Corporation Taxes: Dividends Received Deduction #23627").[9]

e. The insurance industry maintains that §24110 is capable of reformation, in a manner to provide a 100% deduction for insurance company dividends. The effect of *Ceridian* for years after 1997 is likely to be the object of subsequent litigation.

5. If the Franchise Tax Board is sustained on the view that insurance dividends are wholly taxable for years after 1997 (in the absence of legislative action), there is likely to be considerable pressure challenging the position asserted in Legal Ruling 385 that a unitary insurance company must be excluded from the combined report of its taxable members. A number of insurance industry representatives have argued that the appropriate methodology for treating taxable corporations that are unitary with their insurance company affiliates is to combine the income and factors of the insurance company with the income and factors of the taxable corporation, and then reflect the exempt status of the insurance company by simply not taxing combined reporting income that is properly apportioned to the insurance company. Under that analysis, the insurance company income would be included in the combined report of the taxable corporation, but the dividends would be eliminated under CRTC §25106.[10]

6. If it were authorized, such a combined report would present numerous difficulties, discussed in greater detail below.

B. Other States

Most states have in lieu premiums tax similar to California and prevent combination. A minority of states tax insurance companies on income with a credit against premiums tax paid or permit an election between premiums tax and income tax, e.g., Florida, Indiana, Louisiana, Mississippi, Montana, Nebraska, New Hampshire, Oregon, Tennessee, and Wisconsin. See Appendix C.

In Florida, for example, the tax base of an insurance company is apportioned to Florida by multiplying the base by a fraction, the numerator of which is the direct premiums

[9] In a related matter, on a petition for writ of mandamus, Superior Court Judge R. Robie held that, after *Ceridian*, the entirety of Section 24410 is invalid and that the Franchise Tax Board lacks the authority to regulate with respect to a statute declared to be unconstitutional. *Allianz of America Inc, et.al v. Connell, et. al* No. 01CS01530 (Cal. Super. Ct., Dec. 24, 2001).

[10] CRTC §25106 generally provides that to the extent a dividend has been paid out of a pool of income that has been included in a combined report (i.e., "determined with reference to the income and apportionment factors of another corporation") with respect to another member of the unitary group, the dividend is eliminated from the recipient's income.

written for insurance upon properties and risks in Florida and the denominator of which is the direct premiums written for insurance upon properties and risks everywhere. "Direct premiums written" means the total amount of direct premiums written, assessments, and annuity considerations, as reported for the taxable year or period on the annual statement filed by the company with the Commissioner of Insurance.

VII. Combination of General Corporations, Financial Corporations, Securities Dealers and Insurance Companies--California.

A. Combination of a General Corporation and a Financial Corporation, with the General as the Predominant Member.

1. 18 CCR §25137-10 provides special rules of combination if a unitary business consists of banks or financial corporations (as defined in 18 CCR §23183) and general corporations (those subject to taxation under CRTC §23151). However, its scope is limited to a unitary combination "whose predominate activity is other than financial activity…" 18 CCR §25137-10(b)(4) provides that "[a]n activity is predominant when its conduct gives rise to gross income which constitutes more than 50 percent of the unitary business's gross income."[11]

2. If the regulation applies, both the general corporation and the financial corporation include lending intangibles in the property factor (in the case of a general corporation, intangibles included are "receivables arising from the sale of tangible property through the extension of credit.") In the application of that regulation, only 20% of the value of intangibles (loans and credit card receivables) is included in property factor. The effect of the regulation is that lending intangibles are weighed substantially less than the traditional property factor items consisting of real and tangible property. The rationale of the weighting of the property factor appears to be that because lending intangibles tend to be highly leveraged by debt, they tend to be less productive of income of a corporation than the general property assets of the unitary group.

3. Because the regulation applies only to general dominant unitary groups, and the property factor is limited to receivables from the sale of tangible property, the scope of the regulation appears to be limited. The problem that the regulation appears to address seems to be limited to corporations that sell tangible personal property on credit (e.g., department stores, auto companies, etc.).

[11] As noted, California Revenue and Taxation Code ("CRTC") § 24271 defines gross income by incorporating the Internal Revenue Code ("IRC") § 61 definition of gross income. Accordingly, gross income includes gains from sales and not gross receipts. (See Treas. Reg. 1.61-6.)

4. Because the §25137-10 regulation limits the general corporation receivables to the sale of tangible personal property, there is an issue of how to combine a general corporation (e.g., a securities firm) that is the predominant earner of gross income within a unitary group that includes a traditional financial corporation. 18 CCR §25137-10(a)(2) states that the unitary business subject to this regulation would "normally" include the combination of a service company and a financial company, where the financial company performs financial functions which are ancillary to the parent's business. It is not clear whether a group that has a dominant securities business and a traditional savings and loan could invoke the regulation. To do so, the savings and loan would have to be considered performing ancillary financial functions on behalf of its parent. It is also not clear the extent to which a situation that is not considered "normal" could nevertheless cause the regulation to apply. Assuming the §25137-10 regulation does apply, then the financial would include 20% of its receivables in the property factor, but the securities firm would not include any of its receivables in the property factor, e.g., margin loans. If the §25137-10 regulation did not apply, would the financial corporation include 100% of its interest bearing loans and receivables in the property factor?

B. Combination of a General Corporation and a Financial Corporation, in General.

1. The scope of 18 CCR §25137-4.2 (the general regulation for apportionment of bank and financial income extends to banks corporations that are defined as financial corporations in 18 CCR §23183 (i.e., dealing in moneyed capital in substantial competition with national banks). That section, in turn applies to the specific legal entity for purposes of the imposition of tax under CRTC §23183. That would suggest that the application of the apportionment rules in 18 CCR §25137-4.2 would be determined on an entity-by-entity approach. One issue that arises when applying the preponderance activity test for assigning loans and receivables: Is that test is applied on a unitary basis or on an entity-by-entity basis?

a. The entity-by-entity approach could have peculiar effects within a combined reporting group. Thus, if a financial group had some subsidiaries within it, some of which exceeded the 50% gross income from moneyed capital threshold and some of which did not, even though the subsidiaries had substantial, traditional financial services activity in substantial competition with national banks, those specific entities would be required to apportion reflecting a standard UDITPA property factor (excluding intangibles) and standard UDITPA sales factors (reflecting the greater cost of performance).

b. If the overall activity of the unitary group is predominantly financial, the "separate accounting" aspects of entity-by-entity determination of application of the standard apportionment factors could be difficult to apply, and could produce disparate results, depending upon whether

the financial activity of each entity is above or below the 50% line. This effect becomes more pronounced, given the California limitations requiring gross income to be measured with respect to "moneyed capital." Thus, as financial deregulation permits traditional banks and financials (directly or through subsidiaries) to engage in greater degrees of financial service activity, the more pronounced (and arbitrary) the 50% line might appear.

2. To address the concerns just stated, an alternative approach might be to consider that the financial regulations should apply to the entire unitary group if the unitary group, taken as a whole, has more than 50% of its gross income from moneyed capital. There is support in unitary principle that says the business income of all members of a unitary group should be apportioned in the same manner as if the members were divisions of a single corporation, which would suggest that an entire business enterprise approach might be more appropriate.

    a. This approach would arguably require a broadening of the specific entity approach that the reference to 18 CCR §23183 suggests. In order to do so, either the Franchise Tax Board or the taxpayer would arguably have to resort to the bare authority of CRTC §25137.

        (1) Under the *Appeal of Fluor Corporation*, Cal. St. Bd. of Equal., 95-SBE-010, special regulations adopted under §25137 have the same force as statutory and regulatory provisions under the general provisions of UDITPA, and the party seeking to avoid application of a special regulation must meet the same burden of proof as they would with respect to variations from the general provisions of UDITPA.

        (2) Under *Appeal of New York Football Giants*, Cal. St. Bd. of Equal., 77-SBE-014, if the Franchise Tax Board is the moving party, it would bear the burden of proof.

        (3) To meet that burden, the Franchise Tax Board would arguably have to address the impact of *Appeal of Merrill Lynch*, which stated that a mere mathematical difference in apportionment result would not be sufficient to sustain the application of Section 25137.[12]

[12] The *Appeal of Merrill Lynch*, supra, (arguably in dicta) also considered what percentage change might be appropriate before the Board of Equalization would consider the apportionment formula to be sufficiently distortive for relief to be appropriate under CRTC §25137. The Board appears to have backed off applying a percentage test for distortion in *Appeal of Crisa Corp.*, Cal. St. Bd. of Equal., June 20, 2002, (pet. for reh. pending), in favor of a more "facts and circumstances" test. Whether *Crisa* would impact the analysis here is uncertain.

b. However, application of a group-as-a-whole financial apportionment rule could create its own problems. If the group as a whole was close to but not over 50% of its gross income from moneyed capital, the effect of totally disregarding a major component of financial activity with the corporate group might also be seen as failing to reflect the material contributions of the financial assets of the group in producing business income. Widely divergent apportionment approaches would apply for entities just above and just below the 50% gross income line.

c. If combination of financial corporations and general corporations becomes more likely under deregulation, should there be consideration of a relative weighting of lending receipts analogous to the 20% weighting that applies to combination of general dominant groups under 18 CCR §25137-10? Is it fair to say that the relative weighting of such assets is appropriate for all combination of general and financial activity?

C. Combination of Financial Corporation and Securities Dealers.

1. The specific effect of combination of financial corporations and securities dealers presents its own set of problems. The effect of *Merrill Lynch* with respect to securities dealers (underwriting sales and principal asset sales reflected as a gross receipt in the sales factor) could easily result in the sales factor (perhaps double weighted) swamping the effects of other sales of the rest of the group. For example, in the unpublished opinion of *Appeal of Fuji Bank*, date, the stockbroker member of the unitary group only contributed 2.6% of the business income of the group, but under *Merrill Lynch*, its underwriting and principal asset sales produced 99.6% of the sales factor denominator.

2. Arguably, placing the bank and financial corporations sales of notes, securities, trading assets, credit card receivables, etc. on a net income basis, and the securities firms principal trading asset and underwriting receipts at gross fails to reflect the relative contribution of the respective market states for these industries. Is there sufficient difference between a bank's trading assets and the principal asset sales of a securities dealer to consider the former at net and the latter using gross receipts? Is the solution to place securities corporations gains on a net basis, or to inflate the bank's sales of financial instruments to reflect gross receipts? Would that cause other distortions with respect to the rest of the financial corporation's sales, in contravention of the rationale which put sales of loans and credit card receivables at net in the first place? Is process of origination of loans, followed by their immediate securitization for a sale to third party customers all that different from the role of an underwriter's sales of securities, taking title only briefly in a transaction between the issuer and the ultimate customer? Is there a sufficient difference to justify net income treatment in the sales factor for the former and gross receipt treatment for the latter?

3. The same problems are present in the property factor, as well. Is it possible that a bank's loans and credit card receivables would have the effect of swamping the probably minor real and tangible personal property of the securities dealer? Is appropriate to discount the loans of the bank (perhaps by the same 20% in the provisions of 18 CCR §25137-10) and include the margin lending accounts of the stockbroker in the property factor (similarly discounted)? Should the principal trading assets of the stockbroker also be considered in the property factor, analogous to the inclusion of bank loans in the property factor for the financial apportionment rules? Should there be some discounting of those values as well? Should banks be given representation for their trading assets in the property factor to match similar assets of a broker?

4. Does the "swamping" effect in the sales factor (shifting income toward the securities dealer) offset the "swamping effect" in the property factor (shifting income toward the financial)? For purposes of that analysis, does it matter that one factor might be double weighted? Do the effects really offset, in any event? Even if the effects offset as between the financial group and the securities group as a whole, is the offset effect really going to be realized at the individual state level, because the property factor state for one member may not be the same as the sales factor state for the other?

5. Assume that the group test suggested above were to apply (i.e., that would apply the 50% gross income test to the entire unitary group and apply the financial apportionment rules to the entire unitary group). Would the MTC rules be sufficiently broad in scope to place underwriting sales and principal asset sales at net income for purposes of the sales factor? For example, is an underwriting transaction a transaction involving "trading assets" within the meaning of the MTC regulation? Does it make sense for *Merrill Lynch* to apply (underwriting at gross) in a group 51% dominated by a securities dealer, but to apply the underwriting receipts at net if 51% dominated by a financial?

6. If the apportionment rules are applied to the individual members, and not on a group basis, very significant differences can occur with respect to the treatment of very similar transactions. Not only is the gross-versus-net issue in the sales factor a problem, but interest income is assigned to the market for a financial, whereas margin account lending for a stockbroker will be assigned based on the greater cost of performance rule. Bank loans would be in the property factor whereas margin loans would not.

D. Combination of Insurance Companies.

1. If the pressure caused by the aftermath of the *Ceridian* decision pushes for revision or rejection of Legal Ruling 385, insurance company income could be included in the combined report of a taxable corporation. Financial

deregulation may make it more likely that such an insurance company would be held by a financial corporation or a securities dealer, which would raise some of the combination issues discussed above, and a few others.

2. Because insurance companies are not themselves taxpayers (because of the provisions of the "in lieu") how would the business income of the insurance company be defined in the combined report? California does not conform to the provisions of Subchapter L of the Internal Revenue Code. Without legislation, by what authority would the Franchise Tax Board compute the tax base of an insurance company to take into account, for example, insurance reserves? Would the general income tax law apply (e.g., would deductions be allowed for insurance claim payments only when made)? The apportionment rules traditionally do not affect the tax base itself (see Pierce, *The Uniform Division of Income for State Tax Purposes* (1957) 35 Taxes 747;[13] *Appeal of Crisa Corporation,* June 20, 2002, (pet. for reh. pending); *Appeal of CTI Holdings, Inc.*, Cal. St. Bd. of Equal., 96-SBE-003). Does this suggest that legislation might be necessary to define the tax base of the insurance company?

3. Should there be special numerator rules to locationally assign premium receipts to the state of the customer (analogous to the location rules for the gross premiums tax) for purposes of the sales factor instead of the greater cost of performance rule?

4. Should the investment assets of the insurance company be reflected in the property factor? Should there be a discount for their value analogous to 18 CCR §25137-10? Where would they be assigned for numerator purposes? Would there be a SINNA rule comparable for banks, or would the investment more properly be assigned to the location of the insurance risk? Is a numerator rule even necessary, if the insurer is exempt in the state where the numerator exists?

5. Are the special rules necessary to place so-called "independent agents" in the payroll factor?

6. How would the respective apportionment rules be integrated if a financial services group consisted of a financial group, a securities group and an insurance group?

[13] [UDITPA] assumes that the existing state legislation *has defined the base of the tax* and that the only remaining problem is the amount of the base that should be assigned to the particular taxing jurisdiction. Thus, the statute does not deal with the problem of ascertaining the items used in computing income or the allowable items of expense. (Pierce, supra, at p. 747, emphasis in original).

7. Who has the expertise and the authority to do it all? Does this call for a broad multistate project analogous to the MTC financial regulation project? Does the limited adoption of the MTC financial regulation bode well for uniformity?

VIII. Unitary Combination, Other States.

A. Combination of Securities Firms with Banks and Financials

1. New York. Combined returns may be permitted or required under Article 32 for banking corporations as defined by Article 32, but combination is not permitted with corporations taxed under Article 9-A. Corporations taxed under Article 9-A, typically file on a separate return basis. Broker-dealers may become subject to tax under Article 32 if owned by a bank-holding company. In that instance, banks and broker-dealers are under the same apportionment methodology, and the California combination issues are avoided.

As part of its 2000 budget bill, New York enacted provisions to address the consequences the Gramm-Leach-Bliley Act will have on New York taxpayers. President Clinton signed the Gramm-Leach-Bliley ("Act") into law November 12, 1999. The Act repeals the 66-year old Glass-Steagall Act, which prohibited banks, securities firms and insurance companies from affiliating. The Act permits banks, securities firms, and insurance companies to affiliate with a new financial holding company ("FHC") structure. The act prohibits non-financial companies from owning commercial banks. Under the Act, bank holding companies that qualify can elect to be treated as FHCs.

In general, the statute is designed to retain the *status quo*. Basically, the transition rules provide that a corporation that was classified as a bank in 1999 will remain classified as a bank in 2000. Similarly, a general business corporation (an Article 9A taxpayer) that was a New York taxpayer in 1999 will not be required to file as a bank in 2000, as result of being acquired by a bank in 2000. For tax years beginning on or after January 1, 2002: (a) certain corporations that were taxed under the corporate franchise tax or the bank franchise tax in 2000 are allowed to maintain that taxable status in 2001 and 2002; and (b) certain corporations that are owned by financial holding companies or that are financial subsidiaries of banks are permitted to elect to be taxed under either the corporate franchise tax or the bank franchise tax in 2001 and 2002. Similar changes were made to the New York City Administrative Code.

2. Other States. Similar to New York, other states have avoided the California combination issues, by providing that all entities in a combined report be subject to the same apportionment formula. One way to achieve this would be to use the MTC proposed definition of a financial corporation, which would include subsidiaries. In addition, if the subsidiary rule does not apply (for example, the parent company is not a bank holding company), legislation could

be enacted for sales of securities to be included on a net gain basis in the receipts factor. Colorado (for example) has enacted a statute providing that "[t]he gross receipts regarding the sale of intangible assets shall be the gain from the sale and not the total selling price." Colo. Rev. Stat. § 39-22-30(4)(b).

B. Combination with Insurance Companies

Most states have an in lieu premiums tax similar to California and prevent combination. For states that tax the income of an insurance company, combination may be permitted. In Florida, for example, insurance companies are subject to the corporate income tax and a gross premiums tax, with a credit against the premiums tax for the corporate income tax paid. In Florida, a consolidated return election can be made, which would include insurance companies that are included in the Federal consolidated return.

An insurance company that is part of the Florida consolidated return, must file as part of the group and apportion income on the basis of the standard apportionment factors. It cannot apportion income on the basis of the special apportionment methods. The numerators of the insurance company sales, property, and payroll factors are determined by multiplying the denominator of each factor by the premiums factor ratio. Florida Statutes § 220.131(5).

Appendix A

Multistate Tax Commission Model Rules Defining a Financial Corporation

The elements of the MTC definition are listed below and has been adopted all or in part in some of the states that have adopted the MTC financial regulations. Note that subsidiaries of the defined financial corporations are also covered by the MTC regulations. MTC suggested proposal - "Financial Institution" means:

a. Any corporation or other business entity registered under state law as a bank holding company or registered under the Federal Bank Holding Company Act of 1956, as amended, or registered as savings and loan holding company under the Federal National Housing Act, as amended;

b. A national bank organized and existing as a national bank association pursuant to the provisions of the National Bank Act, 12 U.S.C. §§21 et seq.;

c. A savings association or federal savings bank as defined in the Federal Deposit Insurance Act, 12 U.S.C.§ 1813(b)(1);

d. Any bank or thrift institution incorporated or organized under the laws of any state;

e. Any corporation organized under the provisions of 12 U.S.C.611 to 631.

f. Any agency or branch of a foreign depository as defined in 12 U.S.C. 3101;

g. A state credit union the loan assets of which exceed $50,000,000 as of the first day of its taxable year;

h. A production credit association organized under the Federal Farm Credit Act of 1933, all of whose stock held by the Federal Production Credit Corporation has been retired;

i. Any corporation whose voting stock is more than fifty percent (50%) owned, directly or indirectly, by any person or business entity described in subsections (1) through (8) above other than an insurance company taxable under [insert applicable state statute] or a company taxable under [insert applicable state statute];

j. A corporation or other business entity that derives more than fifty percent (50%) of its total gross income for financial accounting purposes from finance leases. For purposes of this subsection, a "finance lease" shall mean – any lease

transaction which is the functional equivalent of an extension of credit and that transfers substantially all of the benefits and risks incident to the ownership of property. The phrase shall include any "direct financing lease" or "leverage lease" that meets the criteria of Financial Accounting Standards Board Statement No. 13, "Accounting for Leases" or any other lease that is accounted for as a financing by a 1essor under generally accepted accounting principles. For this classification to apply,

i. The average of the gross income in the current tax year and immediately preceding two tax years must satisfy the more than fifty percent (50%) requirement; and
ii. Gross income from incidental or occasional transaction shall be disregarded; or

k. Any other person or business entity, other than [an insurance company taxable under _____], [a real estate broker taxable under _____], [a securities dealer taxable under _____], or [a _____ company taxable under _____], which derives more than fifty percent (50%) of its gross income from activities that a person described in subsections (2) through (8) and (10) above is authorized to transact. For the purpose of this subsection, the computation of gross income shall not include income from non-recurring, extraordinary items.

l. The [State Tax Administrator] is authorized to exclude any person from the application of subsection (11) upon such person proving, by clear and convincing evidence, that the income-production activity of such person is not in substantial competition with those persons described subsections (2) through (8) and (10) above.

Appendix B

MTC Apportionment Regulations for Financial Institutions

RECIEPTS		PROPERTY	
Lease (or sublease) of Real Property	Location of Property.	Owned Real & Tangible Personal Property [average value at cost]	- Non-Transportation Property: Located where Property is physically located, situated or used.
Lease of Tangible Personal Property	- Non-Transportation Property: Location of Property when first put in service by Lessee. - Transportation Property: To the extent used in State. If can't be determined, then 100% to state where Property has its principal base of operation (where regularly directed or controlled). Aircraft: ratio of instate landings; Motor Vehicle: 100% to state of registration.	Rented Real & Tangible Personal Property [gross rent payable during the year x 8]	- Transportation Property: To the extent used in State. If can't be determined, then 100% to state where Property has its principal base of operation (where regularly directed or controlled). Aircraft: ratio of instate landings; Motor Vehicle: 100% to state of registration.
Interest From Loans Secured by Real Property [50% or more of aggregate FMV (valued at time loan made) of collateral used to secure loan was real property]	Determined at time of original agreement: -Property in 1 State: Location of Property. -If Property w/in & w/o, then 100% to the State where > 50% of the FMV of Property located; if > 50% of the FMV not located in any 1 State then Location of Borrower.	Loans [valued at outstanding principal balance, w/o regard to any reserve for bad debts. If a loan is charged-off in whole or in part for Fed. tax purposes, the portion of the loan charged off is not outstanding. A specifically allocated reserve established pursuant to regulatory or financial accounting guidelines which is treated as charged-off for Federal tax purposes shall be treated as charged-off for purposes of this section]. Credit Card	Receivables [valued at outstanding principal balance w/o regard to any reserve for bad debts. If a receivable is charged-off in whole or in part for Federal tax purposes, the portion of the receivable charged-off is not outstanding.] NOTE: Credit Card Receivables are sourced pursuant to the same rules as Loans.
Interest From Loans Not Secured by Real	Location of Borrower. [If engaged in		

Property	trade/business--commercial domicile. If not engaged in trade/business--billing address.		
Net Gains (but not < 0) from Sale of Loans [includes income recorded under the coupon-stripping rules of IRC 1286]	-Secured by real property: Multiply net gain by instate interest from loans secured by such property/all interest from loans secured by real property. -Not Secured by real property: Multiply net gain by instate interest from loans not secured by such property/all interest from loans not secured by real property.	Assigned to a regular place of business of taxpayer w/in State where loan has a preponderance of Substantive Contacts. Presumed proper if: 1. Taxpayer has assigned such loan on its records consistent with Federal or state regulatory requirements. 2. Such assignment is based upon Substantive Contacts of loan to such regular place of business. 3. Taxpayer uses said records for filing all state returns for which an assignment of loans to a regular place of business is required.	
Credit Card Receivables [Includes interest, fees, penalties in the nature of interest, and annual fees]	Cardholder's Billing Address [Location indicated in taxpayer's records on 1st day of tax year (or on date customer relationship began) where any notice, statement &/or bill is mailed.]	Substantive Contacts - These activities are located at regular place of business which taxpayer's employee is regularly connected with or working out of, regardless of where the services of such employee were actually performed: 1. Solicitation - Either active (taxpayer initiates contact) or passive (customer initiates contact).	
Net Gains (but not < 0) from Sale of Credit Card Receivables	Multiply net gain by instate receipts from credit card receivables/ all such receipts.	2. Investigation - Procedure whereby taxpayer's employees determine creditworthiness as well as degree of risk.	
Credit Card Issuer's Reimbursement Fees	Multiply all reimbursement fees by instate receipts from credit card receivables/all such receipts.	3. Negotiation - Procedure whereby taxpayer's employees determine terms of agreement (i.e., amount, duration, interest rate, frequency of repayment, currency denomination & security required).	

Merchant Discount [net of any cardholder charge-backs but not reduced by any interchange transaction fees or by any issuer's reimbursement fees paid to another for charges made by its cardholders]	Merchant's Commercial Domicile.	4. Approval - Procedure whereby taxpayer's employees or Board of Directors make final determination whether to enter into the agreement. If Board makes final determination, such activity is located at taxpayer's commercial domicile. 5. Administration - Process of managing the account (i.e., bookkeeping, collecting the payments, corresponding with customers, reporting to management regarding the status of the agreement & proceeding against the borrower or the security interest if the borrower is in default. Such activity is located at the regular place of business which oversees this activity.
Loan Servicing Fees	-Fees from Servicing Loans Secured by real property: Multiply fees by instate interest from loans secured by such property/all interest from loans secured by real property.	NOTE: Absent any change of material fact, loan shall remain assigned to State for the length of the original term of the loan. Thereafter, loan may be properly assigned to another state if loan has a preponderance of substantive contact to a regular place of business there.
	-Fees from Servicing Loans Not Secured by real property: Multiply fees by instate interest from loans not secured by such property/all interest from loans not secured by real property.	
	-Fees from Servicing Loans of Another: Location of Borrower.	
Services [receipts not otherwise apportioned] - Investment Assets: Interest, dividends, net gains (not < 0).	100% where greater proportion of income-producing activity is performed based on cost of performance.	
- Federal Funds/Repos: Amount by which interest income exceeds interest expense. - Trading Assets: Amount by which interest, dividends, gains & other income exceed amounts paid in lieu of interest, dividends, & losses from such assets & activities.	In all cases, Taxpayer may elect or State may require in order to fairly represent taxpayer's instate business activities, ratio based on gross income instead of average value of assets. -Investment Assets: Multiply by average value of such assets assigned to a regular place of business of taxpayer/average value of all such assets.	

	-Federal Funds & Repos: Multiply by average value of such assets assigned to regular place of business of taxpayer/average value of all such assets.	
	-Trading Assets: Multiply by average value of such assets assigned to a regular place of business of taxpayer/average value of all such assets.	
All Other Receipts	Particular state's situs rule inserted.	**PAYROLL**
Throwback Rule	UDITPA	Includes only compensation paid to employees in the production of business income. Payroll in State if any of following tests, applied consecutively, is met: 1. Services performed entirely in State. 2. Services performed outside State are incidental (temporary, transitory in nature, rendered in connection with an isolated transaction). 3. If performed w/in & w/o, then (A) where employee's principal base of operation is; or (B) if no principal base of operation in any state in which service is performed, then where directed or controlled; (C) if principal base of operation & place from which directed or controlled are not in state in which service is performed, then employee's residence.

MTC Scorecard				
State	Earlier Draft Version Adopted	Final Version Adopted	Modified Version Adopted	Action Taken/Pending
AL				
AK				
AZ				
AR		1-1-96		
CA		1-1-96		
CO		6-1-97		
CT				
DE				
DC				
FL				
GA				
HI		1-1-96		
ID		1-1-96		
IL				
IN	1-1-90			
IA				1996 receipts only conformity failed.
KS		7-1-96		
KY		7-15-96		Franchise tax measured by net capital.
LA				
ME			1-1-97	Double-weighted Receipts Factor.
MD			1-1-98	Double-weighted Receipts Factor.
MA		1-1-95		
MI				
MN	1-1-87			75% Receipts, 12.5% Payroll, 12.5% Property
MS		1-1-97		
MO				
MT				
NE				
NV	N/A	N/A	N/A	
NH			1-1-96	Double-weighted Receipts Factor.
NJ				1995 conformity attempt failed
NM		1-1-96		
NY				
NC				
ND		1-1-97		
OH			1-1-98	Franchise tax on net worth. Apportionment formula: 70% Receipts, 15% Payroll, 15% Property.
OK				
OR			1-1-93	Double-weighted Receipts Factor.
PA				
RI		7-1-96		
SC				
SD				
TN	7-15-90			
TX				1995 conformity attempt failed
UT		1-1-98		
VT				
VA				

WA		7-1-97		
WV	1-1-91			
WI				
WY	N/A	N/A	N/A	

Appendix C

2566 Corporate Income Taxes—Charts[14] 1314 12-2001

Insurance Companies

¶ 10-103

Most states do not impose a corporate income tax on insurance companies doing business in their state, but rather impose a tax on gross premiums. Those states that do impose corporate income tax on insurance companies are set out on the chart below, as well as whether there are any special provisions relative to insurance companies in determining taxable income, special modification to taxable income, or special apportionment provisions.

States that are not included in the chart do not impose a corporate income tax on insurance companies.

State	Tax	Modified Base	Special Modifications	Special Apportionment
Florida	Corporate income with credit against premiums tax	Offset provisions	None	Special factor apportionment
Illinois	Corporate income	Special base for life insurers, interinsurers, and reciprocal underwriters	None	Single factor apportionment
Indiana	Election between corporate income or premiums; domestic insurers subject to supplemental net income tax	None	None	Single factor apportionment
Louisiana	Corporate income with credit for premium taxes paid	Varies by insurance type	Varies by insurance type	Not apportioned
Michigan	Single business tax and surcharge	Special base; limited exemption for disability prms.	Yes	Single factor apportionment

[14] Commerce Clearing House

Mississippi	Corporate income	Yes	Yes	Only for non-life insurers

State	Tax	Modified Base	Special Modifications	Special Apportionment
Montana	Election between corporate license tax and premiums tax	None	None	None
Nebraska	Corporate income with credit for premiums taxes paid	None	None	Single factor apportionment
New Hampshire	Business profits with credit for premiums tax paid	None	None	None
New York	Not subject to general state franchise (income) tax; subject to a number of insurance specific franchise taxes	None	None	None
Oregon	Corporate excise with credit for premiums taxes paid	Yes	Yes	Modified three factor apportionment
Tennessee	Excise tax with credit for premiums taxes paid; additional deduction for excise phaseout (1998—2992(	None	Yes	Single factor apportionment
Wisconsin	Corporate income or premiums tax, depending on insurance type	No	Yes	Two factor apportionment